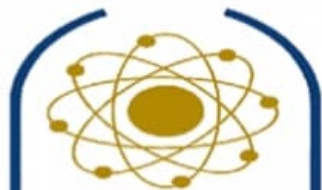


Public Finance

Chapter 6

Approaches to Tax Equity

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Distribution of the Burden of Government Finance:

- A basic problem in government finance is to distribute among citizens the burden of financing the costs of government goods and services.
- Two approaches are used in determining the distribution of the burden of government finance: The Benefit Principle and The Ability-to-Pay Principle.





1- The Benefit Principle

- The benefits principle of taxation states that only the beneficiaries of a particular government program should have to pay for it.
- Examples of that are tolls for road and bridge use, fares for use of public transportation.
- An advantage of this principle is that it links the cost per unit of government supplied services with the marginal benefits of those services.
- However, the practical application of the benefits principle is extremely limited because most government services are consumed by the community as a whole (non-excludable services).





2- The Ability-to-Pay Principle

- The ability-to-pay principle holds that people's taxes should be based upon their ability to pay, usually as measured by income or wealth.
- One implication of this principle is *horizontal equity*, which states that people in equal positions should pay the same amount of tax.
- A second requirement of the ability-to-pay principle is *vertical equity* which implies that a person with a higher income should pay more in taxes than one with less income.





Criteria for Evaluating Alternative Methods of Government Finance:

- **Equity:** The distribution of the burden of government finance should be compatible with fairness and the ability to pay.
- **Efficiency:** The system of government finance should raise revenues with only minimal loss in efficiency in the private sector.
- **Administrative ease:** A government finance system should be relatively easy to administer in a consistent manner, without excessive costs to collect.





Equity versus Efficiency

- The goals of efficiency and equity in the distribution of taxes among citizens are likely to conflict.
- Methods of government finance that minimize losses in efficiency in markets are not always considered desirable by all citizens. (e.g. pollution tax)
- The trade-off between an equitable and an efficient system of government finance must be resolved through political interaction.
- In real world, under a system of compulsory finance, the resulting structure of government finance will be neither efficient nor equitable from the point of view of all individuals.





Tax Compliance and Evasion

1) Tax Evasion

- It is non-compliance with the tax laws by failing to pay taxes that are due.
- The term is used for illegal ways of avoiding paying taxes. It is typically the result of not declaring income or overstating otherwise legal deductions.
- The incentives for evasion by individuals depend on benefits expected from non-compliance.
- Tax evasion, of course, resulted in costs which vary with the penalties involved and the probability of being caught by authorities.





Tax Compliance and Evasion

2) Tax Avoidance

- It is change in behavior to reduce tax liability.
- Examples: high taxes on labor income might induce workers to refuse overtime work.
- Clearly, tax avoidance is a legal way of avoiding paying taxes.
- Tax evasion is illegal, whereas tax avoidance involves adjusting the extent to which one engages in a taxed activity in response to the rate at which that activity is taxed.





Reducing Tax Evasion

- Non-compliance with tax laws reduces revenues collected for any given tax rate structure.
- The greater the non-compliance, the higher the tax rate necessary to raise any given amount of revenues per year.
- Understanding the incentives for tax provides a useful starting point to develop policies to fight it.





Reducing Tax Evasion

- Costs and benefits are associated with tax evasion.
- The **benefit** to the taxpayer is the reduction in taxes while the **costs** are the penalties, both monetary and otherwise, that the taxpayer will incur if caught.
- Regarding taxpayers, **the marginal benefit** of tax evasion is the amount of taxes not paid, and this depends on the taxpayer's **Marginal Tax Rate (MTR)**.





Reducing Tax Evasion

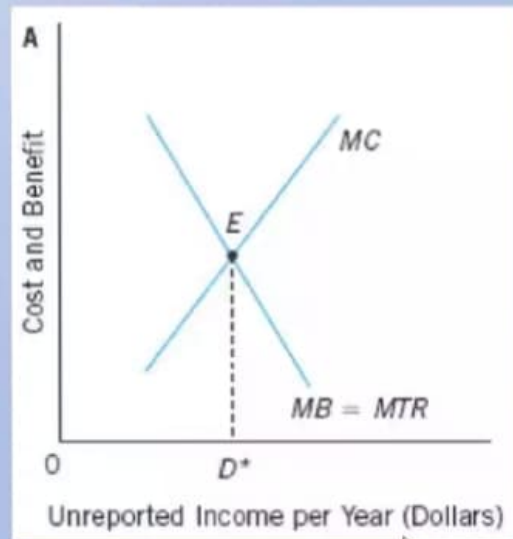
- Assume that the taxpayer is subject to a **progressive tax rate** structure, as is the case under the personal income tax.
- Here the marginal benefit of a dollar of tax evasion declines as more taxable income is not reported because tax evasion pushes the taxpayer into lower tax brackets.





Reducing Tax Evasion

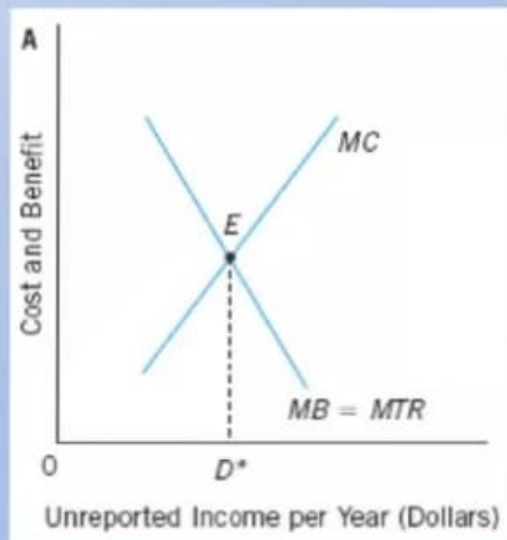
- Reduction in MTRs reduces marginal benefit of tax evasion, resulting in downward shift of marginal benefit curve.
- The expected MC of tax evasion is likely to rise, because taxpayers are likely to reason that both the probability of detection and the penalty will increase as more taxable income is not reported each year.





Reducing Tax Evasion

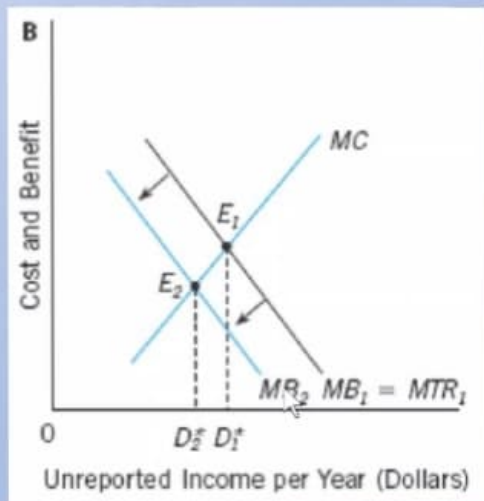
- The optimal amount of tax evasion in form of unreported income corresponds to the point at which MC of tax evasion = MB and this occurs when D^* dollars per year are not reported.





Reducing Tax Evasion

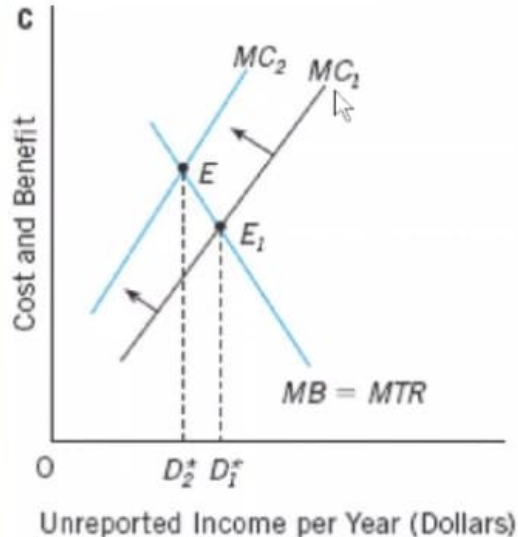
- If the tax law changes and results in a reduction in MTRs, and then reduces the marginal benefit of tax evasion.
- This will result in a downward shift in the marginal benefit curve and a decrease in unreported income.
- This will result in tax evasion declines from $D1^*$ to $D2^*$.
- This also could be done by increasing the moral pressures against tax evasion.





Reducing Tax Evasion

- If MC of tax evasion increases, the amount of tax evasion declines. This can be done by increasing the penalties to taxpayers who are detected.
- After MC shifts from MC_1 to MC_2 , tax evasion declines from D_1 to D_2 .
- If the probability of detection were 100%, or if the penalties were severe, the optimal amount of tax evasion to any citizen could fall to zero.



Thank You
For good listening

